

CalPERS Investment Beliefs

Adopted September 16, 2013

In September 2013, the CalPERS Board of Administration adopted a set of ten Investment Beliefs intended to provide a basis for strategic management of the investment portfolio, inform organizational priorities, and ensure alignment between the Board and CalPERS staff.

The Investment Beliefs are not a checklist to be applied to every decision. They are a guide for making decisions that often require balancing multiple, inter-related decision factors. They provide context for CalPERS actions, reflect CalPERS values, and acknowledge CalPERS responsibility to sustain its ability to pay benefits for generations.

Investment Belief 1

Liabilities must influence the asset structure

Sub-beliefs:

- Ensuring the ability to pay promised benefits by maintaining an adequate funding status is the primary measure of success for CalPERS
- CalPERS has a large and growing cash requirement and inflation-sensitive liabilities; assets that generate cash and hedge inflation should be an important part of the CalPERS investment strategy
- CalPERS cares about both the income and appreciation components of total return
- Concentrations of illiquid assets must be managed to ensure sufficient availability of cash to meet obligations to beneficiaries

Investment Belief 2

A long time investment horizon is a responsibility and an advantage

Long time horizon requires that CalPERS:

- Consider the impact of its actions on future generations of members and taxpayers
- Encourage investee companies and external managers to consider the long-term impact of their actions
- Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives
- Advocate for public policies that promote fair, orderly and effectively regulated capital markets

Long time horizon enables CalPERS to:

- Invest in illiquid assets, provided an appropriate premium is earned for illiquidity risk
- Invest in opportunistic strategies, providing liquidity when the market is short of it
- Take advantage of factors that materialize slowly such as demographic trends
- Tolerate some volatility in asset values and returns, as long as sufficient liquidity is available

Investment Belief 3

CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries

Sub-beliefs:

- As a public agency, CalPERS has many stakeholders who express opinions on investment strategy or ask CalPERS to engage on an issue. CalPERS preferred means of responding to issues raised by stakeholders is engagement
- CalPERS primary stakeholders are members/beneficiaries, employers, and California taxpayers as these stakeholders bear the economic consequences of CalPERS investment decisions
- In considering whether to engage on issues raised by stakeholders, CalPERS will use the following prioritization framework:
 - » Principles and Policy – to what extent is the issue supported by CalPERS Investment Beliefs, Principles of Accountable Corporate Governance or other Investment Policy?
 - » Materiality – does the issue have the potential for an impact on portfolio risk or return?
 - » Definition and Likelihood of Success – is success likely, in that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success or would someone else be more suited to carry the issue?
 - » Capacity – does CalPERS have the expertise, resources and standing to influence an outcome?

Investment Belief 4

Long-term value creation requires effective management of three forms of capital: financial, physical and human

Sub-beliefs:

- Governance is the primary tool to align interests between CalPERS and managers of its capital, including investee companies and external managers
- Strong governance, along with effective management of environmental and human capital factors, increases the likelihood that companies will perform over the long-term and manage risk effectively
- CalPERS may engage investee companies and external managers on their governance and sustainability issues, including:
 - » Governance practices, including but not limited to alignment of interests
 - » Risk management practices
 - » Human capital practices, including but not limited to fair labor practices, health and safety, responsible contracting and diversity
 - » Environmental practices, including but not limited to climate change and natural resource availability

Investment Belief 5

CalPERS must articulate its investment goals and performance measures and ensure clear accountability for their execution

Sub-beliefs:

- A key success measure for the CalPERS investment program is delivery of the long-term target return for the fund
- The long time horizon of the fund poses challenges in aligning interests of the fund with staff and external managers
- Staff can be measured on returns relative to an appropriate benchmark, but staff performance plans should include additional objectives or key performance indicators to align staff with the fund's long-term goals
- Each asset class should have explicit alignment of interest principles for its external managers

Investment Belief 6

Strategic asset allocation is the dominant determinant of portfolio risk and return

Sub-beliefs:

- CalPERS strategic asset allocation process transforms the fund's required rate of return to the market exposures that staff will manage
- CalPERS will aim to diversify its overall portfolio across distinct risk factors / return drivers
- CalPERS will seek to add value with disciplined, dynamic asset allocation processes, such as mean reversion. The processes must reflect CalPERS characteristics, such as time horizon and size of assets
- CalPERS will consider investment strategies if they have the potential to have a material impact on portfolio risk and return

Investment Belief 7

CalPERS will take risk only where we have a strong belief we will be rewarded for it

Sub-beliefs:

- An expectation of a return premium is required to take risk; CalPERS aims to maximize return for the risk taken
- Markets are not perfectly efficient, but inefficiencies are difficult to exploit after costs
- CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management
- CalPERS should measure its investment performance relative to a reference portfolio of public, passively managed assets to ensure that active risk is being compensated at the Total Fund level over the long-term

Investment Belief 8

Costs matter and need to be effectively managed

Sub-beliefs:

- CalPERS will balance risk, return and cost when choosing and evaluating investment managers and investment strategies
- Transparency of the total costs to manage the CalPERS portfolio is required of CalPERS business partners and itself
- Performance fee arrangements and incentive compensation plans should align the interests of the fund, staff and external managers
- CalPERS will seek to capture a larger share of economic returns by using our size to maximize our negotiating leverage. We will also seek to reduce cost, risk and complexity related to manager selection and oversight
- When deciding how to implement an investment strategy, CalPERS will implement in the most cost effective manner

Investment Belief 9

Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error

Sub-beliefs:

- CalPERS shall develop a broad set of investment and actuarial risk measures and clear processes for managing risk
- The path of returns matters, because highly volatile returns can have unexpected impacts on contribution rates and funding status
- As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns

Investment Belief 10

Strong processes and teamwork and deep resources are needed to achieve CalPERS goals and objectives

Sub-beliefs:

- Diversity of talent (including a broad range of education, experience, perspectives and skills) at all levels (Board, staff, external managers, corporate boards) is important
- CalPERS must consider the government agency constraints under which it operates (e.g., compensation, civil service rules, contracting, transparency) when choosing its strategic asset allocation and investment strategies
- CalPERS will be best positioned for success if it:
 - » Has strong governance
 - » Operates with effective, clear processes
 - » Focuses resources on highest value activities
 - » Aligns interests through well designed compensation structures
 - » Employs professionals who have intellectual rigor, deep domain knowledge, a broad range of experience and a commitment to implement CalPERS Investment Beliefs

CalPERS is the largest public pension fund in the U.S., with more than \$265 billion in assets. We administer health and retirement benefits on behalf of 3,064 public school, local agency and State employers. Our members number more than 1.6 million in our retirement system and more than 1.3 million in our health plans. For more information about the Investment Beliefs and the CalPERS Asset Liability Management Process, visit: www.calpers.ca.gov/alm.



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